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## Creditor's Right in Assets Pledged for Surety's Protection

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## CREDITOR'S RIGHT IN ASSETS PLEDGED FOR SURETY'S PROTECTION

A recent West Virginia case<sup>1</sup> raises the problem of a creditor's right, by a process of equitable subrogation, to reach security given to protect the surety. This problem becomes of importance when the debtor and the surety are insolvent, and the creditor's legal remedies, except that of a share of the assets, are exhausted. It is also raised in many cases, when the creditor does not wish the delay and expense of legal action against the debtor or surety, and attempts the quicker remedy of an equitable suit to reach the security.

In dealing with this problem it is essential to draw a distinction between two classes of cases: (1) where the security to which the creditor seeks to be subrogated was given by the principal debtor; and (2) where the security was given by a third person.

Keeping this distinction in mind, we turn to the authority governing the first class of cases. The general rule is that where the principal debtor puts up the security the creditor may reach it in satisfaction of his debt. This rule may be traced back to a dictum in *Maure v. Harrison*,<sup>2</sup> to the effect that "a bond creditor may have the benefit of all . . . security given by the principal to the surety". In subsequent cases this rule has not been followed altogether, but a further distinction in fact has been made, on which the decision may turn. Thus we see that where the intent of the parties is to protect the creditor as well as the surety, the creditor is universally allowed the benefit of such security, on the basis that an express trust in his favor has been created.<sup>3</sup> But where the security is given solely to protect the surety, the creditor's right, if any, to the security must be worked out on the theory of a constructive trust or similar implication of law.<sup>4</sup>

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<sup>1</sup> *Shawver v. Board of Education of Loudon Dist.*, 186 S. E. 307 (W. Va. 1936).

<sup>2</sup> 1 Eq. Cas. Abr. 93 (1692).

<sup>3</sup> Note (1887) 1 HARV. L. REV. 326.

<sup>4</sup> The cases in which recovery may be worked out on the theory of a third party beneficiary contract are few. See *Beacon Lamp v. Travellers' Ins. Co.*, 61 N. J. Eq. 59, 47 Atl. 579 (1902); Note (1918) 28 YALE L. J. 706. The cases usually raise an implied trust in favor of the creditor. This rationale is shown by the fact that the Statute of Limitations does not run on this right as it would on an ordinary contract right. See *Webster v. Mitchell*, 22 Fed. 869 (1884); *Whitehead v. Henderson*, 67 Ark. 200, 56 S. W. 1065 (1899); *Eastman v. Foster*, 8 Metc. 19, 24 (Mass. 1845). The distinction between the

A definite split of authority marks these cases, and for purposes of discussion it is necessary to divide them into three groups: (1) The American courts adopted the rule stated in *Maure v. Harrison* at an early date,<sup>5</sup> and most American jurisdictions follow it to-day.<sup>6</sup> (2) The English cases, however, repudiating *Maure v. Harrison*,<sup>7</sup> allow the creditor to recover the security only where both the principal debtor and the surety are insolvent.<sup>8</sup> A few American courts use this approach. There appears to be only one West Virginia case on the point. The court in that case based its decision in favor of the creditor on the fact that the debtor and the surety were both insolvent, but made no statement as to what it would have held otherwise.<sup>9</sup> Despite the absence of a square holding, however, the attitude of our court seems to indicate that West Virginia would follow the English rule. (3) The Scotch rule, followed by a few American states, is that the creditor may not have the benefit of the security unless there is an express trust in his favor.<sup>10</sup>

The reason for this split of authority is apparent. In the first place there is the logical difficulty of working out a recovery in any case where the parties had no intention to benefit the creditor and the further lack of a logical basis for distinction on the ground of insolvency.<sup>11</sup> On the other hand, there is the obvious injustice of refusing the creditor, balked in his attempt to collect at law, the benefit of this security or even of compelling him to sue at law when the only objection to allowing the suit in equity would be that legal remedies had not been exhausted. Although the ends of justice are probably better served by the rule which allows subrogation in any case than by either other rule, the fact

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various methods of working out recovery is discussed in a note, L. R. A. 1916C 1070, 1075. See to the effect that a creditor may not enforce a right in equity to this security until all legal remedies are exhausted, *Saffold v. Wade's Ex'r*, 51 Ala. 214 (1878).

<sup>5</sup> *Moses v. Murgatroyd*, 1 Johns. Ch. 119 (N. Y. 1814).

<sup>6</sup> *Demott v. Stockton Paper Co.*, 32 N. J. Eq. 124 (1880); *Jack v. Morrison*, 28 Pa. 113 (1857); *Kunkel v. Fitzhugh*, 22 Md. 567 (1864); *Bank v. Cummings*, 29 N. Y. S. 782 (1894), *aff'd* 149 N. Y. 364, 44 N. E. 173 (1895). Some courts condition this recovery on the insolvency of the surety, although there appears to be no logical basis for the distinction. *Jones v. Quinpiack Bank*, 29 Conn. 25 (1860). See Note (1887) 1 HARV. L. REV. 326.

<sup>7</sup> *In re Walker*, 1 Ch. 621 (1892).

<sup>8</sup> *Ex parte Waring*, 19 Ves. 345 (1815); *Ex parte Smart*, L. R. 8 Ch. 220 (1872); *In re Belfast Warehouse Co., Ir.* Ch. 124 (1897); *Dyer v. Jacoway*, 76 Ark. 171, 88 S. W. 901 (1905).

<sup>9</sup> *Farmer's Produce Nat. Bank v. Hart*, 103 W. Va. 290, 137 S. E. 222 (1927).

<sup>10</sup> *Royal Bank v. Commercial Bank*, L. R. 7 App. 366 (1882); *Pool v. Dos-ter*, 59 Miss. 258 (1881).

that logic is strained a trifle to reach that result should not be overlooked.

This difficulty in reaching a conclusion is not manifested in the second class of cases, where the security is furnished by a third party, and in that case the courts seem to have had no hesitation in refusing to subrogate the creditor to the surety's right in the security. The leading case on the point in this country, *Hampton v. Phipps*,<sup>12</sup> refused this relief where the security was given by co-sureties to one another to protect them from liability beyond the proportion each assumed. The holding in this case is even stronger in view of the fact that both sureties were insolvent. In the course of its opinion the court said that an opposite result would tend to defeat the clear intent of the parties, and would often work a palpable injustice, by misdirecting a stranger's benevolence.

The question in the recent West Virginia case, *Shawver v. Board of Education of Loudon Dist.*,<sup>13</sup> was the responsibility of a surety's indemnitor, a stranger to the original transaction, to the creditors of the surety's principal. The court refused relief, holding that the gratuitous indemnity furnished by a stranger for the express benefit of the surety is not impressed with a trust in favor of the creditors of the principal debtor. No mention was made of the fact that in this case a promise to pay was involved, whereas usually property is pledged as security, and it seems that there is no reasonable distinction on that basis. The case is well within the scope of rules as established in other jurisdictions,<sup>14</sup> and in line with a distinction made by all courts.<sup>15</sup>

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<sup>11</sup> Note (1887) 1 HARV. L. REV. 326, 333.

<sup>12</sup> 108 U. S. 260, 2 S. Ct. 622 (1882).

<sup>13</sup> 186 S. E. 307 (W. Va. 1936). This case is further complicated by the fact that the creditor's right against the surety is based on a third party beneficiary contract, the suretyship contract being the contractor's bond required by W. VA. CODE (1931) c. 38, art. 2, § 39. For the purposes of this note, that complication is not important.

<sup>14</sup> ARANT, SURETYSHIP (1931) 375; 1 BRANDT, SURETYSHIP AND GUARANTY (1905) 690; *Hampton v. Phipps*, 108 U. S. 360, 2 S. Ct. 622 (1882); *Hasbrouck v. Carr*, 19 N. M. 586, 145 Pac. 133 (1914); *United States v. United Surety Co.*, 192 Fed. 992 (1912); *Henderson-Achert Lith. Co. v. Shillito Co.*, 64 Ohio St. 236, 60 N. E. 295 (1901); *Taylor v. Farmers' Bank of Ky.*, 87 Ky. 398, 9 S. W. 240 (1888); *Macklin v. Northern Bank*, 83 Ky. 314 (1885); *Black v. Kaiser*, 91 Ky. 422, 16 S. W. 89 (1891); *O'Neill v. Savings Bank*, 34 Mont. 571, 87 Pac. 970 (1906), where a statute giving the creditor the right of subrogation was interpreted not to cover this situation.

<sup>15</sup> *Caueat*: It is important to distinguish between the various fact situations, there being little difficulty with respect to the applicable rules of law.